Cytonn Monthly - April 2015

Cytonn Weekly

Executive Summary

- **Fixed Income:** IMF maintains Kenya?s GDP growth forecast at 6.9% for the year, despite security concerns and the shilling?s volatility against the dollar;
- **Equity Market:** The equities market declined during the month with the NASI falling 1.5%, with the trend expected to continue given stretched valuations and lower expected earnings;
- **Private Equity:** Development funds increasingly partnering with private investments to fund mega projects in Africa;
- **Real Estate:** Cytonn expectations continue to be validated as land prices continue to increase, driven by rapid urbanisation and relaxation of zoning laws;
- **Focus of the month:** Government?s debt levels remain sustainable despite the expenditure rising faster than revenues.

Fixed Income Update

The government securities markets witnessed lower subscription rates in the month of April compared to the first quarter due to quarterly corporate tax remittances, the 12-year infrastructure bond tap sale that raised Kshs 24 billion, and fewer government bond maturities. However, yields remained unchanged at 8.4%, 10.3% and 10.6% for the 91-day, 182-day and 364-day papers, respectively. Investors continue to seek direction on the movement of interest rates.

The Kenya shilling posted a loss of 2.4% during the month of April against the dollar, to close at a 3-year low of 94.6. The depreciation is attributed to the deadly terrorist attack in Garissa University, the dollar demand from corporates as they sought to pay dividends to foreign shareholders and dollar strengthening on the back of positive economic data in the US. Despite the lower than average exports from the country, in the medium term we expect the shilling will be supported by the central bank?s increased activity in the market, and a weaker dollar as the Fed restrains from interest rates hikes.

Despite a slowdown in economic growth from 5.7% in 2013 to 5.3% in 2014, both the government and the IMF maintain a GDP growth forecast of 6.9% for 2015. The forecast growth is above the average Sub-Saharan Africa?s 4.5% projected GDP growth rate.

In the near-term, we see risk of rate hikes in Kenya due to the depreciating shilling and increasing inflation rate. We would be biased towards short durations.

Equities Update

During the month, the Nairobi Securities Exchange experienced a decline; with the NSE All share Index and NSE 20 index registering losses of 1.5% and 3.5%, respectively. The decline was led by a drop in Britam and Kenya Airways, which fell 16% and 13%, respectively.

An amendment to Kenya?s Companies Act, which seeks to allow companies with excess cash to reduce the number of shares available for trading through share buybacks, has gone through the first reading in the National Assembly. If implemented, companies can use the share repurchases to support their share price when they feel the market does not reflect the true value of their stock, and investors who opt to sell benefit from a ready buyer.

The ability to buy back shares will be a catalyst for companies to adopt share-based incentive schemes because the dilution from employee share awards can be sanitized through share buybacks. We strongly believe that share-based incentive schemes will strengthen alignment between management and shareholders, thereby improving corporate performance. Companies that have share-based incentive schemes tend to outperform their peers.

Notwithstanding the high expected GDP growth rate in the country, and Kenya?s good rating in global markets, we expect the stock market to underperform in Q2 2015 given the current stretched valuations and lower than historical earnings growth, as highlighted in our Quarter 1, 2015 report.

Private Equity Update

In H1 2015, we see a trend in development funds blending with private investments to fund mega projects. The EU, together with Paris-based PE firm Astor Capital Partners, intends to invest in energy companies in Kenya, Uganda and Rwanda before moving on to West Africa. As part of the deal, Astor Capital will put in Euros 55 million over the next 5 years in 20 businesses while European Investment Bank (EIB) will put in Euros 10 million. Energy Access Ventures Funds will deploy the cash to buy equity stakes in SMEs dealing with electricity provision and ancillary activities including solar home devices. Earlier this month we also saw Norfund, Norway?s development fund, partnering with Britain?s development fund CDC to buy a stake in Globeleq Africa in a plan to increase its investment in Sub Saharan Africa up to three-fold in the next five years.

Development funds are accountable for their performance to investors just like any other investment companies. The Funds seek to harness the potential for bringing in expertise and efficiencies in the private sector to earn above average returns. In return, development funds? equity investments act as catalyst for growth, job creation and spur innovation while attracting more investors to the region. This reaffirms Cytonn?s strategy of adding value by investing in companies in the private sector to help our investors earn above average returns by leveraging the opportunities presented by the existing gaps in the market.

Real Estate Update

This month saw the release of Q1 Housing Price Index by Kenya Banker?s association and Hass Consult?s land price index. The real estate market still remains buoyant with appreciating values, but with a change in growth areas. The Housing Price Index recorded an increase in the price of apartments with size, gated communities and social amenities as key drivers of price. This is reaffirmed in the Hass Consult Residential prices index, which recorded a 12.3% price hike in the price for apartments over the last 1 year. Semi-detached houses are currently fetching the highest annual rental yields of 7.8% as compared to 7.1% for apartments and 6.1% for detached houses. The total return (capital appreciation + yield) is at 19%, which is attractive given a government 12-year bond yields 12%.

The Hass Consult Land index showed an increase of 17.6% for land prices over the last 12 months and a 4.5% for the quarter. On the high-density development land segment, Upperhill has the most expensive land with Karen being the cheapest in absolute terms. Lavington saw the highest price increment in the last quarter. Parklands has the most expensive land in the medium development land segment, with Donholm registering depreciation in land value of 1.2%. Land prices are increasing at a decreasing rate since 2007, indicating the way to uncover returns in real estate is being a step ahead and identifying the next area that will see a price appreciation. Commercial land is fetching more than residential.

Factors such as the expected next growth area (as per the infrastructural developments), the type of the development and the land zoning play a crucial role in expected price appreciation. A blend of these different factors is necessary to harness the best returns. For example, low-density areas like Karen with semi-detached houses, which have seen a stable increase in the asking price in a gated community with good social amenities, will do well in the future. High-density, low end, areas will do well with apartments, which are currently seeing a rental yield of 7.0%. Cytonn?s conviction is that Karen will offer the best returns over the next five years given the lowest absolute relative valuation and the continued relaxation of zoning regulations.

Focus of the Month: Review of Kenya?s debt sustainability in the wake of the 2015/2016 budget

The Kenyan economy has done really well over the last few years, and according to the government the picture is even rosier as they project the GDP to grow at 6.9% in this financial year, despite the insecurity challenges facing the country.

On the back of this accelerated projected growth rate, the cabinet approved the 2015/2016 budget that will be read in parliament, and passed, in the month of June. Of key note is that the total government expenditure has continued to grow, almost doubling over the last five years. However, revenue growth has not kept pace, growing at 59% over the same period. The only mitigation to expenditure growth far outpacing revenue growth is that a majority of expenditure is allocated towards development, which has more than doubled, while the recurrent expenditure has grown by 15% over the same period.

The faster growth in government expenses compared to revenue has led to an increase in total government debt, both domestic and external. However, despite all this, the Kenyan government?s debt remains sustainable at a 43.7% Debt-GDP ratio. For Kenya, this ratio provides comfort that the debt levels are still sustainable; given emerging markets across Africa, Asia and Latin America have ratios averaging over 50%. The domestic debt has grown over time, leading to a deepening of the capital markets, as the central bank continues to issue longer dated securities. Despite our view that the debt is sustainable, the government needs to be cautious, since the cost of financing government expenditure continues to increase, yet it will take time before we reap returns from the investment in infrastructure development.

The projected increase in government debt, coupled with the expected volatility in the shilling, all point towards the rates remaining sticky with a possible risk of an increase in the short term. The projection of increased foreign debt also, despite providing short-term support to the shilling, opens the country to external global economic shocks.

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